Overview

Global economic growth slowed late in 2011, but that has not developed into a major downturn and a number of indicators suggest that, outside of Europe, conditions have stabilised over recent months. The US economy has continued to expand at a moderate pace over the year to date and there are tentative signs that activity in east Asia is continuing to pick up after the effects of the natural disasters of 2011. Growth has slowed to a more sustainable pace in China, largely reflecting the effect of tighter domestic policies, which has helped to ease inflationary pressures. Nonetheless, the Chinese economy still grew by about 8 per cent over the year to March.

Conditions in Europe, in contrast, remain very difficult. Some progress has been made in addressing fiscal imbalances and implementing structural reforms, but much work remains to be done. Activity in Europe is still contracting, with a negative feedback loop between fiscal consolidation and growth evident in a number of countries. This is weighing on business and consumer confidence across the region.

Notwithstanding the ongoing problems in Europe, the recent flow of information has, at least for the time being, ended the sequence of downward revisions to expectations of global growth, and some forecasters have in fact increased their estimates a little. Global growth is now expected to be around 3½ per cent in 2012 and around 4 per cent (about trend) in 2013. As has been the case over recent years, emerging market economies, particularly in Asia, are expected to be the main driver of global growth. Activity in the advanced economies is likely to be subdued given the need for fiscal consolidation and the ongoing effects of deleveraging by the private sector. It remains the case that, given the nature of the challenges faced by many advanced economies, the risks to global growth remain on the down side. Global inflationary pressures remain moderate, despite some boost to headline measures from elevated oil prices.

This outlook for near-term global growth – below trend growth, but not a major slump – is broadly consistent with developments in commodity prices. The spot price for iron ore has moved a little higher since the start of the year, consistent with signs of a recovery in Chinese steel production and some earlier disruptions to supply in Australia and Brazil. Coking coal prices have eased as supply from Queensland has recently returned to its level prior to the flooding in early 2011. Prices for base metals and rural commodities have declined more recently, but they remain at historically high levels. After peaking in the September quarter 2011, the terms of trade are estimated to have declined, though they remain high. The terms of trade are expected to continue to decline gradually over coming years, as significant investments under way in Australia and elsewhere boost the supply of bulk commodities, but to remain well above their longer-term average.

Global financial market sentiment has generally improved over the year to date. This was underpinned by further European Central Bank actions to bolster liquidity and the restructuring of Greek public debt held by the private sector. More recently there has been some widening of spreads on government bonds for vulnerable countries. Nevertheless, in contrast to the situation towards the end of last year, so far this year capital markets have been supplying funding to corporations and highly rated banks. This has enabled sizeable issuance of bonds by Australian banks. Moreover, at the margin, wholesale funding costs have declined over recent months, although they remain higher (relative to benchmark rates) than in mid 2011. At the same time, elevated competitive pressures have kept deposit rates in Australia high relative to the cash rate.

Although three months ago a range of indicators were suggesting that economic growth was close to trend, the outcome for 2011 as now reported was, in fact, somewhat weaker than that. Domestic demand in 2011 increased by close to what had been expected, and grew at its fastest pace for four years, but its composition has progressively shifted, with even more mining sector investment than anticipated a year ago, and less non-mining activity. Moreover, more demand may be spilling abroad via imports. As a result, labour market conditions have continued to be on the soft side to date, with large increases in employment in mining and some service industries roughly offset by declines in the manufacturing, hospitality and retail sectors.

Over 2012 to date, partial indicators and liaison suggest that the economy has been growing modestly, but with activity continuing to vary significantly across industries. The mining sector remains exceptionally strong, with work progressing on the very large pipeline of committed projects and capital imports rising. Mining production, though, has been disrupted recently by adverse weather and industrial action.

Growth in household spending moderated at the end of 2011 and partial indicators suggest that it remained soft in early 2012. There has been very low growth in the value of retail sales in particular, though this has been weaker than overall consumption for some time. The housing market and residential building activity also remain weak. Demand for new housing finance has eased slightly in recent months, despite interest rate reductions late last year. There are tentative signs that dwelling prices have declined more gradually than was the case in late 2011, but to date the market for established dwellings has remained subdued. At this stage, the available forward-looking indicators suggest that a recovery in housing construction is unlikely in the near term. But with mortgage servicing costs falling relative to incomes, rental yields rising and ongoing population growth, some important conditions for a recovery in construction are in place. What remains is for buyers to reach a point where they have sufficient confidence to commit to contracts for construction of new dwellings, and for the supply side of the housing market to be responsive to demand. Under those conditions, a soundly based recovery in construction could be expected.

Employment growth picked up a little in the March quarter of 2012, after the flat outcome in 2011. The softness over the past year includes the net effect of structural change, with mining and some service industries expanding, while firms in many other industries have reduced employment to contain costs and improve productivity in the face of modest growth in demand. Leading indicators, such as surveys and job vacancies, paint a mixed picture but are generally consistent with ongoing modest employment growth in the near term. A key issue over the next couple of years will be how effectively growing vacancies in some sectors can be filled with labour displaced from other areas.

The growth of wages appears to have moderated slightly over 2011. In the private sector, wages grew at a pace that was a little below the elevated rates seen over 2005–2008; wage growth softened by more than this in the public sector. Business surveys and liaison suggest that private sector wage pressures may have eased a little further in the March quarter, consistent with the generally subdued demand for labour outside the resource sector.

A year ago, underlying inflation had reached a low point of about 2¼ per cent and was forecast to increase to be close to the top of the inflation target range by the end of 2011, in line with the positive outlook for the economy. Inflation did pick up a bit initially, but began to moderate in the second half of the year, as weakness in demand in some key domestic sectors of the economy put pressure on margins. The fall in prices for fruit and vegetables that had been affected by natural disasters in early 2011 occurred largely as expected. Accordingly, CPI inflation fell very sharply.

Inflation in the March quarter was unusually low, with various measures indicating underlying inflation was around ¼ per cent in the quarter. On a year-ended basis, underlying inflation declined to 2–2¼ per cent. The headline CPI fell by 0.2 per cent in the quarter on a seasonally adjusted basis, to be 1.6 per cent higher over the year. There was a large fall in fruit prices, especially of bananas, which subtracted 0.3 percentage points from quarterly inflation. The prices of a range of other tradable items, including some household goods, clothing and overseas holidays, also declined – reflecting both softness in consumer demand and some further pass-through of the earlier exchange rate appreciation. Non-tradables price rises were also a little softer, increasing by 0.7 per cent in the quarter and by 3½ per cent over the year. Within non-tradables, the prices of new dwellings and domestic travel & accommodation declined, although there were still quite strong increases in a number of services prices. The slowing inflation in some non-tradables prices, and some part of the decline in tradables prices, suggests pressure on margins, probably reflecting relative softness in demand in some non-mining sectors.

The Bank's central forecasts for the aggregate economy have been revised marginally lower. GDP is expected to grow by about 3 per cent over 2012 and 2013, and by a little bit more than that over the year to mid 2014. Employment growth is expected to remain subdued in the near term.

Over the forecast period, growth in domestic demand is expected to slightly exceed its long-run average. This reflects the ongoing boom in mining investment, the outlook for which has been revised higher. This strength is anticipated to provide some stimulus to a number of other sectors and in regions where the mining investment is most concentrated. At the same time, however, the assumed high level of the exchange rate and a weak short-term outlook for building construction are expected to result in subdued growth outside of the mining sector in the near term, though there are reasonable grounds to expect stronger growth in the non-mining sector over a medium-term horizon. Public demand is expected to decline over the year ahead. Exports have been revised lower, largely reflecting a reassessment of the ability of mining companies to utilise new transport and port capacity fully in the near term, along with weaker manufacturing exports.

The most significant external risk to this outlook is the possibility that sovereign debt problems in Europe could intensify and derail the upswing in the global economy. While the likelihood of this occurring in the near term has eased somewhat in recent months, partly because of the actions of authorities in Europe, the situation remains fragile. A substantial deterioration of conditions in Europe would be likely to have flow-on effects to the rest of the world through trade, financial and confidence channels. A sharp slowdown in global activity, particularly if it flowed through to east Asia, would have significant implications for commodity prices and demand for Australian exports, while a major flight from risk in global capital markets would see a marked deterioration in credit conditions and confidence. Even so, Australia remains relatively well placed to respond in such circumstances given the scope to adjust macroeconomic policies, the flexible exchange rate and a robust financial system.

In terms of risks on the domestic front, there is the possibility that in the near term, labour shedding across a range of industries outside of the mining sector accelerates as firms continue to adjust to the high exchange rate, weakness in the property market and the effects of weaker public demand.

Over the medium term, however, as mining projects progress into the more labour-intensive phase of construction, there is a risk that labour demand could pick up more than forecast.

The outlook for inflation has also been revised down. Underlying inflation (excluding the effect of the carbon price) is forecast to stay close to recent rates over the next one to two years. The key features of this forecast are: a decline in domestically generated inflation pressure; at the same time, the decline in tradables prices observed recently diminishes, given that the exchange rate has been little changed for a year now and is assumed not to change in the forecast period. The decline in domestically generated inflation rests on a couple of important judgements: that growth of nominal wages will moderate somewhat in a period of soft labour market conditions, and that productivity growth picks up, as firms respond to heightened competitive pressures in an environment of subdued demand and the high exchange rate.

The profile for headline inflation will be affected by a number of one-off factors in the next few quarters. Year-ended headline inflation will remain below underlying inflation given the sharp falls in fruit prices in recent quarters. The introduction of the carbon price in July is expected to boost headline inflation by around 0.7 percentage points over the year to June 2013. The effect on underlying inflation is expected to be less than this, at around ¼ percentage point over the same period. A key assumption made here is that there are no second-round effects owing to higher margins or wage claims.

The Board reduced the cash rate twice in late 2011, which took rates for most borrowers back to about their medium-term average levels. Those rates then retraced a little of that decline during the past few months, as lenders recouped increases in funding costs relative to the cash rate. At its first couple of meetings in 2012, the Board held the cash rate steady, but noted that the inflation outlook would provide scope for easier monetary policy, if needed, to support demand. The data coming to hand over the past two months suggested that it was appropriate for a further step in that direction. Accordingly, at its May meeting, the Board decided on a further reduction in the cash rate. In deciding the size of the adjustment, the Board judged that it was desirable for financial conditions to be easier than those which had prevailed in December, and that this required a 50 basis points reduction in the cash rate, on this occasion, in order to deliver the appropriate level of borrowing rates.

The Board will continue to monitor information on economic and financial conditions and adjust the cash rate as necessary to foster sustainable growth and low inflation.